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WHAT GROWTH IN 2006?

How is economic growth shaping up in 2006? This is a question haunting the Federal Reserve as it debates whether to stop raising interest rates. It inserted in its March 28 FOMC press release a new attempt at transparency: "The slowing of the growth of real GDP in the fourth quarter of 2005 seems largely to have reflected temporary or special factors. Economic growth has rebounded strongly in the current quarter *but appears likely to moderate to a more sustainable pace (my italics)*."

The final revision to the fourth quarter 2005 Gross Domestic Product showed growth was just 1.7 percent, a sharp drop from 4.1 percent growth in the third quarter and 3.5 percent for all of 2005. The main culprit was personal consumption expenditures (PCE), the figure most closely watched by Fed officials, which grew just 0.9 percent in Q4, vs. 4.1 percent in Q3. Final sales, a number that doesn't take into account restocking of inventories, actually shrank 0.2 percent vs. a 4.6 percent increase in Q3 2005.

Why is consumption closely watched? Because new Fed Chairman Bernanke cited a slowdown in consumer spending and increase in personal savings as a perquisite for any change in the Fed's current interest rate policy of tightening, since excess spending contributes to inflation.

But one quarter does not make for a trend, and so the Fed is watching first quarter 2006 economic growth to see if the slowing continues. The latest indications are that consumer spending is ramping up again, with Q4 an aberration due to Hurricane Katrina and elevated energy prices. First quarter GDP growth is predicted to be 5 percent, in part due to unseasonably warm January weather that bumped up home construction (and sales) as well as an unwinding of the hurricanes' effect on consumers.

HOME SALES—February's new-home sales plunged 10.5 percent, and inventories rose to a 6.3-month supply. But existing sales rose 5.2 percent, the biggest gain in 2 years. Housing construction fell 7.9 percent in February, also. All was probably due to the warm January and colder February. The Fed seems to think this is an indication of slowing real estate activity (and slower price appreciation).

INFLATION—Both wholesale (PPI) and retail (CPI) inflation were tame in February. PPI prices actually fell 1.4 percent, with finished energy prices declining 4.7 percent. Inflation does seem to be subsiding, with the latest PCE index most favored by the Fed up just 1.8 percent in a year.

CONSUMER CONFIDENCE—The Conference Board's confidence index fell in February but rose in March to a 4-year high. "The improvement in consumers' assessment of present-day conditions is yet another sign that the economy gained steam in early 2006. (But) Consumer expectations, while improved, remain subdued and still suggest a cooling in activity in the latter half of this year."

"I do think there is some chance we will see increased private sector savings in the next year or two if housing prices were to moderate," Bernanke said, in an earlier address to the Eastern Economic Association. This would help raise the national savings rate, "and would be entirely consistent with continued growth at or near potential, so I don't think it is a problem for the sustained expansion.".

Bernanke said the latest economic evidence supports the Fed's forecast of a moderate slowdown in housing activity, though it is too early to be certain. Housing remains a risk factor going forward, he said in answer to questions from the economists. The buildup of household debt may not be a particularly serious problem for the economy, though. Many homeowners have used mortgage debt to pay off higher costing credit card debt, thus improving their debt situation.

In addition, there will not be a sharp, sudden re-pricing of adjustable rate mortgages. The Fed, according to Bernanke, estimates that the re-pricing of these instruments will happen "slowly". For example, only 10 percent of these loans will re-price in 2006, he said.

The real problem for consumers (and the economy) is that real estate related activity has accounted for almost 50 percent of economic activity in recent years. If the Fed persists in raising interest rates, it will not only affect the real estate sector but overall economic activity. Bernanke's Fed is therefore walking a very fine line.

Chairman Bernanke concluded his remarks to the economists with this admonition: "…policymakers are well advised to follow two principles familiar to navigators throughout the ages: First, determine your position frequently. Second, use as many guides or landmarks as are available." This is also good advice for current and prospective homeowners.

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